



Hong Kong Institute of
Certified Public Accountants
香港會計師公會



Mergers & Acquisitions

The premise for separate accounting
methods

International Forum of Accounting Standard Setters

London 25-26 September 2017



Agenda

- ✓ Background
- ✓ Conceptual Framework considerations
- ✓ IFASS discussion objective
- ✓ Table group discussions
- ✓ Verbal summary



BACKGROUND

What is a Business Combination (BC)

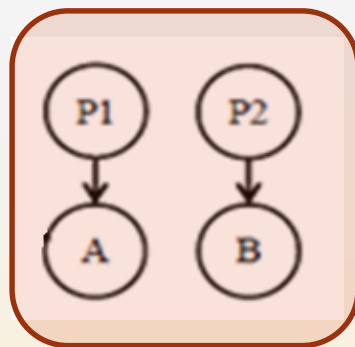
What is a Business Combination under Common Control (BCUCC)

What is the issue at hand

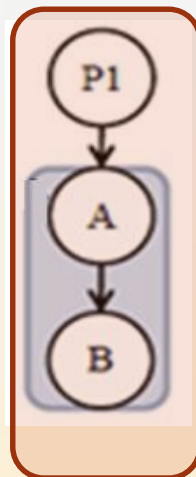
Business Combination (BC)

- ✓ Where an acquirer obtains control of one or more businesses.
- ✓ Usually undertaken to maximize economic benefits by expanding via vertical and/or horizontal integration.

Before:



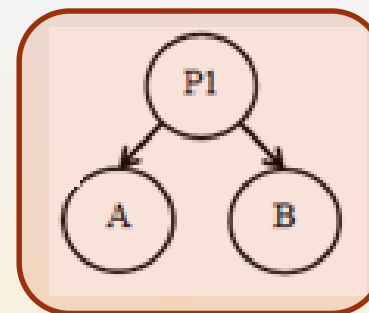
After:



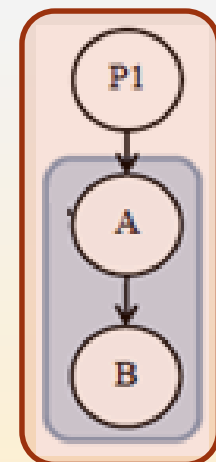
BC under Common Control (BCUCC)

- ✓ Combining businesses are ultimately controlled by the same party(ies), before and after the combination; and control is not transitory.
- ✓ Usually undertaken:
 - to maximize operational efficiencies;
 - for the purposes of an IPO; or
 - For same reasons as a BC.

Before:



After:



What is the issue at hand?

IFRS 3 scope-out

Arguably, BCUCC are different as:

- ✓ they could be internally directed transactions rather than arm's-length exchanges; and
- ✓ the purpose of such transactions could be different (i.e. maximize internal synergies).

Consequences

- ✓ No standard for BCUCC.
- ✓ Under IAS 8, management selects an accounting policy.
- ✓ Diversity in practice, within and across jurisdictions.



CONCEPTUAL FRAMEWORK

(Based on the IASB's tentative decisions in June 2017)

General purpose financial reporting (GPFR) objective

Who is the 'reporting entity'

Characteristics of useful information

GPFR objective

"To provide financial information about the reporting entity that is useful to primary users in making resource allocation decisions

Primary Users

- ✓ Existing and potential investors, lenders and other creditors.
- ✓ Not management, regulators, other public members.

Resource Allocation Decisions

- ✓ to buy, sell or hold equity and debt instruments;
- ✓ to provide or settle loans and other forms of credit;
- ✓ to exercise rights while holding investments; and
- ✓ to assess how well management effectively and efficiently discharges its responsibilities.

Who is the Reporting Entity

"An entity that chooses, or is required, to prepare GPFR"

Boundary

- ✓ Does not have to be a legal entity—can comprise only a portion of an entity or two or more entities.

Perspective

- ✓ Financial information are prepared from the perspective of the reporting entity as a whole, not from the perspective of any particular group of investors, lenders or other creditors.

GPFR needs to describe the economic activities of a reporting entity.

Characteristics of useful information

"Information is useful if it is relevant and faithfully represents what it purports to represent"

Faithful representation

- ✓ Complete, neutral, free from error.
- ✓ Substance of an economic phenomenon instead of legal form.
- ✓ Affected by measurement uncertainty.

Relevance

- ✓ Capable of making a difference in the decisions made by users.
 - Has predictive value, confirmatory value or both.

Comparability, Verifiability, Timeliness and Understandability.

... But, what about cost constraints?



IFASS DISCUSSION OBJECTIVE

Identify principles underlying possible accounting for BCs and BCUCCs

Objective

Today's discussion

- ✓ IFASS will focus on discussing the factors to evaluate the substance underlying the economic phenomena of a BCUCC and a BC.
- ✓ Today's discussion will be the first in a series aimed at assessing:
 - whether and how a BCUCC is different from a BC; and
 - how they should be accounted for.

Possible future discussions

Primary users

- ✓ Who are the primary users of a reporting entity which prepares GPFR?

Useful information

- ✓ What is relevant information to these primary users in a BCUCC compared to a BC?
- ✓ How is a BCUCC faithfully represented in the GPFR as compared to a BC?
- ✓ What about cost constraints?



TABLE GROUP DISCUSSIONS

1. *How should the economic substance of BCs and BCUCCs be evaluated?*
2. *How to identify the acquirer in a merger under common control?*

Table Group Discussions

Staff would like to understand how standard-setters evaluate the substance and how to identify the acquirer in a merger under common control if there is substance and if there is no substance.

Table group leaders will present the results of the discussion.

Instructions

- ✓ Discuss the following slides in your group [45 min].
- ✓ In slides 15 - 16, consider the top five factors that help the group evaluate the substance of the transaction. Are the group's top five factors to evaluate substance in a BCUCC and BC the same? Why or why not?
- ✓ In slides 17-18, please explain your view in identifying the acquirer.

Economic substance

What is economic substance?

- ✓ 'Economic substance' is the bedrock underlying 'faithful representation of financial information' in the *Conceptual Framework*.
- ✓ But, it is not defined in IFRS literature.
- ✓ We also hear preparers, practitioners and investors talk about economic substance but they each have their own interpretation.
- ✓ What then, constitutes economic substance?

Are BCUCCs and BCs different?

- ✓ Despite having no definition, we are often told that the lack of economic substance in some BCUCCs is the reason for a different accounting.
- ✓ The staff of HKICPA and OIC are conducting a study with investors on how they evaluate the underlying substance of BCUCCs and BCs.
- ✓ The findings could form the premise for whether all business combinations should be accounted for in the same way.

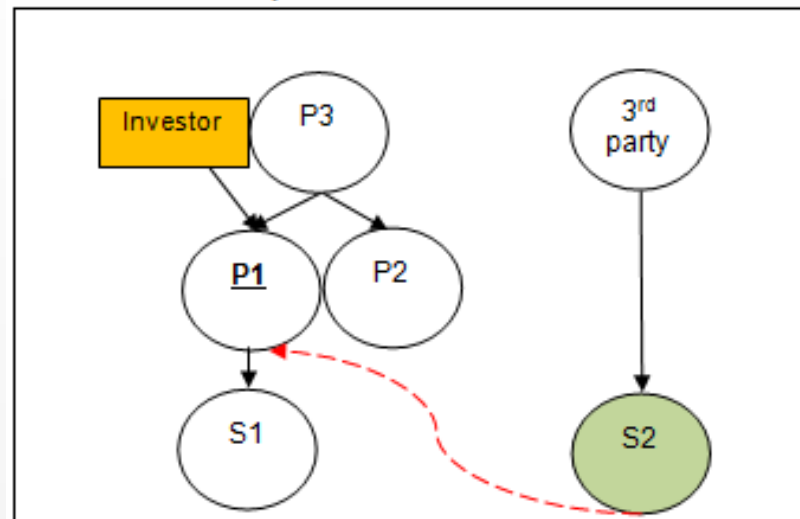
TABLE GROUP DISCUSSIONS (1)

Illustration 1: BC with a third party

When you evaluate the substance of this M&A, how important is:

- Percentage of equity interest acquired;
- Form of consideration;
- Consideration amount;
- Underlying business purpose of the acquisition;
- Principal business activities;
- Management;
- Continuing transactions;
- Minority shareholders;
- Impact on future cash flows & profitability.

Illustration 1: Third Party M&A



- ❑ Assume that you are an equity investor in entity P1.
- ❑ P1 is listed. It owns and controls subsidiary S1.
- ❑ P1 acquires S2 from a third party.
- ❑ P1 and P2 are controlled by P3.

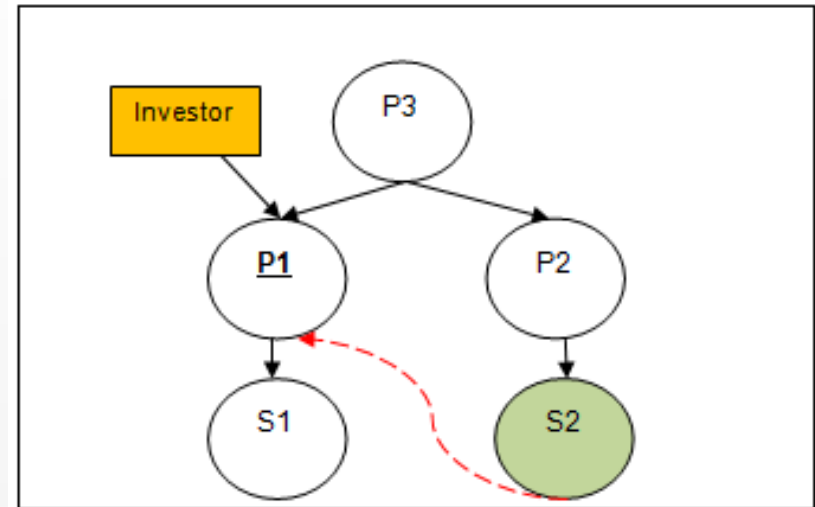
TABLE GROUP DISCUSSIONS (2)

Illustration 2: BC under common control

When you evaluate the substance of this M&A, how important is:

- Percentage of equity interest acquired;
- Form of consideration;
- Consideration amount;
- Underlying business purpose of the acquisition;
- Principal business activities;
- Management;
- Continuing transactions;
- Minority shareholders;
- Impact on future cash flows & profitability.

Illustration: M&A under common control



- ❑ Assume that you are an equity investor in entity P1.
- ❑ P1 is listed. It owns and controls subsidiary S1.
- ❑ P1 acquires S2 from P2.
- ❑ P1 and P2 are controlled by P3.

Identifying the acquirer in a merger under common control

- ✓ IFRS 3 states that “*for each business combination, one of the combining entities shall be identified as the acquirer*”.
 - ✓ IFRS 3 establishes a general principle that, in the BCs, the acquirer is the entity that, in substance, obtains control over the acquiree that is identified as the acquirer.
 - ✓ The entity that issues securities (the legal acquirer) may be identified as the acquiree on the basis of the guidance in paragraphs B13–B18 of IFRS 3.
 - ✓ The acquirer is usually the entity that is significantly greater than the other combining entities.
 - ✓ Is the acquirer always identified?
- ✓ If IFRS 3 is not applied to BCUCC transactions, it is questioned whether an acquirer should be identified in a merger under common control and if so how.
 - ✓ If an acquirer needs to be identified, should the acquirer be the legal acquirer or the substantive acquirer, for accounting purpose, by applying IFRS 3?
 - ✓ In a merger under common control it is impossible to identify the acquirer following IFRS 3 since there is no transfer of control between the controlling shareholders of the combining companies.

TABLE GROUP DISCUSSIONS (3)

Question

In the transaction illustrated, who is the acquirer, for accounting purpose, if there is no economic substance and if there is economic substance?

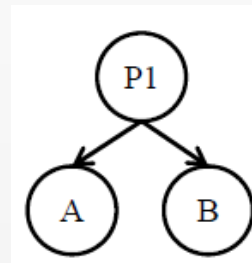
Potential views for discussion

1. Since IFRS 3 does not apply, the legal acquirer is the acquirer also for accounting purposes.
2. The scope out of BCUCC does not imply that the substantive acquirer should not be identified. IFRS 3 is followed.
3. Since no transfer of control happens among shareholders it is impossible to identify the acquirer. Therefore, all the assets and liabilities involved in the combination are recognised at the carrying amounts as resulting from the P1 consolidated financial statements.

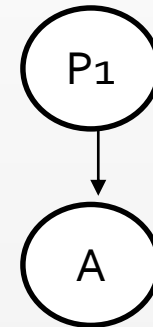
BCUCC

Entity A and Entity B are controlled by the same party, P1. Entity B is merged into Entity A. No cash is transferred

Before BCUCC



After BCUCC



- ❑ Assume that entity B merges into entity A
- ❑ Entity B is much bigger than Entity A
- ❑ A is the legal acquirer



VERBAL SUMMARY

To be provided at IFASS